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EUROPEAN DEBT MUTUALISATION

FINDING A LEGITIMATE BALANCE BETWEEN SOLIDARITY AND RESPONSIBILITY MECHANISMS

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Executive Summary ■

In the upcoming European Council on July 17 and 18, EU member states will fight for a compromise on the European Commission's main project to tackle the economic fallout of the Covid-19 crisis across Europe: a new 7-year EU budget propped up with a temporary Recovery Instrument (Next Generation EU) amounting to EUR 750 bn of jointly issued debt and to be passed on to EU countries as grants and loans. It is one of the most ambitious in a long line of proposals for European debt mutualisation.

While joint borrowing can carry a lot of advantages, debt mutualisation has always been very controversial. Confrontations between those countries supposedly benefiting and losing from mutualising debt have repeatedly centered on the legitimate balance of solidarity and responsibility that such debt implies. Democratic legitimacy in solidarity-responsibility arrangements can be achieved when they can deliver in terms of output legitimacy (being effective in economic terms), input legitimacy (ensuring sufficient room for domestic politics in deciding national policy trajectories) and throughput legitimacy (being run in a transparent and accountable manner).

This paper analyses the solidarity-responsibility arrangements of various proposals and realized forms of European debt mutualisation made over the last decades to evaluate their shortcomings and potential in finding a legitimate balance of solidarity and responsibility mechanisms for all EU member states. Based on this analysis, we make the following key recommendations for the ongoing negotiations on debt mutualisation for a European recovery after the Covid-19 crisis:

- Negotiations in the European Council should not deviate from the model of a crisis specific mechanism for supranational borrowing that relies largely on grants for disbursement. A loans-based approach or an insufficient amount of grants would be harmful and fall short of the substantial macroeconomic stabilisation needed to weather the current crisis.

- The mutualisation of debt repayment (based on grants rather than loans) justifies the inclusion of a certain degree of conditionality. Criteria for the granting and disbursement of funds should be concrete but should also leave sufficient room for countries to set their own policy priorities without excessively interfering with national sovereignty, as it was the case during the Great Recession.

- The assessment process of national recovery and resilience plans financed by Next Generation EU should be transparent and allow for accountability. To guarantee legitimacy and democratic control, we maintain that the Commission is the best-placed institution to make decisions in this regard, subject to the appropriate review of both the Council and the European Parliament.

1 ▪ INTRODUCTION

With the Covid-19 crisis, calls for European debt mutualisation have multiplied to tackle the economic fallout caused by the coronavirus. Following several initiatives from EU member states and policy experts, in late May 2020, the European Commission proposed a Recovery Instrument, called 'Next Generation EU', in the framework of the negotiations on the 2021-2027 EU budget, the multiannual financial framework (MFF). Allowing the EU to raise up to EUR 750 bn to be handed out to member states in the form of grants and loans, this is the latest in a long line of proposals made to mutualise debt at the European level. On July 17 and 18, **a potentially decisive European Council will be dedicated to the question whether the 27 EU member states can find a compromise on the new MFF and Next Generation EU as well as the criteria attached to it.** While backed up by a Franco-German proposal and with broad support from countries hit hard by the coronavirus, the group of the so-called 'Frugal Four' (spearheaded by the Netherlands) is still sceptical of the current proposal for debt mutualisation, particularly the type and extent of policy conditionality for fund disbursement. This opposition is illustrative of **a long-standing controversy on the appropriate and legitimate balance of solidarity and responsibility that joint debt implies** (see Vignon 2011). While joint borrowing is not a new concept in Europe (see section 2 for a historical overview), negotiations on mutualising debt and the attached disbursement, repayment and monitoring conditions have been notoriously difficult since the beginnings of European integration. A myriad of different proposals has been put forward over the course of the last decades, particularly during crisis periods. But only few solidarity-responsibility mechanisms became law in the end, often only after intense political confrontations between member states and inside national parliaments.

Discussions between EU member states have repeatedly circled around **four key issues of solidarity and responsibility (which are detailed in section 3): (1) the economic and political foundations of solidarity in the EU, (2) the different *functions* and associated *forms* of mechanisms to achieve such solidarity in the Union, (3) the nature and scope of solidarity mechanisms, as well as (4) the adequate responsibility mechanisms to ensure that solidarity is not abused.** First, solidarity can be understood either as an insurance mechanism grounded in reciprocity between actors or as an instance of enlightened self-interest (see Fernandes & Rubio 2012). Second, solidarity mechanisms based on common debt can function as a means to provide macro-economic assistance to member states in times of economic turmoil, to restore public finances and improve fiscal discipline across EU member states, to enhance convergence and integration in the Economic and Monetary Union (EMU), and to support national expenditure or investment to prevent procyclicality. These functions can be realised through different forms of solidarity mechanisms, such as a mutualisation of borrowing costs (e.g. based on guarantees, loans, or Eurobonds) or as a mutualisation of debt repayment (e.g. Coronabonds). Third, debt-based solidarity mechanisms can vary significantly in their nature and scope, e.g. regarding their permanent or temporal nature, size, degree of debt mutualisation, degree of liability, repayment dimension, and in their institutional form. And fourth, these different solidarity mechanisms based on common debt can be linked with a diverse set of responsibility mechanisms such as market discipline, fiscal rules, conditionality, and/or soft policy control/budgetary governance.

Negotiations on setting up arrangements of linked solidarity and responsibility mechanisms for joint debt in Europe have been difficult because they have ramifications for democratic legitimacy at the European and national level. This "legitimacy is predicated on governments' ability to govern responsibly and effectively while responding to citizens' political preferences, policy concerns and social values, as expressed directly through the ballot box and/or indirectly via their access to policymaking" (Schmidt 2015:10). Crucially, legitimacy rests on three dimensions: output, input, and throughput legitimacy[1]. The euro area sovereign debt crisis has revealed deep divisions between those countries perceived as 'creditors' and 'debtors' about the design of legitimate solidarity-responsibility arrangements. **Any new proposal for European debt mutualisation thus needs to find a balance between solidarity and responsibility mechanisms that can deliver in terms of output legitimacy** (being effective in economic terms for the whole of Europe and, ultimately, also for individual member states)**, input legitimacy** (ensuring sufficient leeway for democratic politics to decide national policy trajectories) **and throughput legitimacy** (ensuring transparent and accountable procedures).

Based on an analysis of the solidarity-responsibility arrangements of realised forms of European debt mutualisation and various proposals made over the last decades, this policy paper evaluates the capacity of the current Commission proposal to find such a balance (see section 4). **We argue that a solidarity-responsibility arrangement based on a large but limited (both in terms of size and time) solidarity mechanism based on grants, together with concrete conditions and monitoring mechanisms attached to national investment programmes, has the potential to overcome long-standing concerns about the legitimacy of European debt mutualisation across EU member states.** Importantly, however, the criteria attached to the grants and loans need to give enough space for domestic input legitimacy to make the European Recovery Instrument a success. In addition, throughput legitimacy needs to be ensured through transparent and unpoliticised procedures for the granting and disbursement of funds.

To come to this conclusion, the paper is organised as follows. Section 2 gives a concise overview of key proposals and actual implementations of European debt mutualisation over time, covering several phases of European integration: Section 3 moves beyond this detailed descriptive analysis and provides a typology of influential solidarity-responsibility arrangements that were discussed or implemented during the euro area sovereign debt crisis' and the Covid-19 crisis. Section 4 studies the implications of these different arrangements of European debt mutualisation on their legitimacy across EU member states, with a focus on the current Commission proposal. The final section 5 summarizes the key findings of the paper and highlights some remaining pitfalls for any viable debt mutualisation proposal to come.

1. "Output legitimacy depends on the extent to which policy choices provide for the common good and is predicated on those policies' effectiveness and performance. Input legitimacy depends instead on the extent to which policy choices reflect 'the will of the people', which is predicated on citizens' engagement in representative processes and government responsiveness to citizens' concerns and demands. Throughput legitimacy sits between the input and the output, in the 'black box' of governance, and depends on the quality of the policymaking processes, including the efficacy of the policymaking, the accountability of the actors, the transparency of their actions, and their inclusiveness with regard to civil society" (Schmidt 2015:10).

2. EUROPEAN DEBT MUTUALISATION (PROPOSALS) OVER TIME

2.1. Early steps in European debt mutualisation

The earliest example of supranational borrowing in Europe dates back to the 1975 Community Loan Mechanism, set up in response to the negative effects of the first oil shock on member states' balance of payments (see Horn et al. 2020).[2] In this context, the Commission was empowered to issue bonds backed by the Community budget and national guarantees, borrowing funds and lending them on to struggling countries. This instrument was merged in 1988 with an earlier system of bilateral credits (the medium-term financial assistance facility) in the Balance of Payments facility, maintained to the present day for non-EMU members. **The logic of using the Community's favourable credit rating to provide cheap loans to member states set an important precedent that would inform several subsequent instruments and proposals.** A few years later, the so-called MacDougall Report (1977) suggested expanding the Community's borrowing powers for macroeconomic stabilisation, convergence, and industrial development, while recognising the impracticability of full-blown supranational debt financing. Meanwhile, later proposals addressed the infrastructure needs of the continent at a time when national budgets had been constrained by the newly born Maastricht criteria. Stuart Holland (1993) and Jacques Delors (1993), for example, proposed the establishment of a European Investment Fund issuing so-called Union Bonds[3] to support the development of trans-European networks.

2.2. The creation of the EMU and European debt mutualisation

With the launch of the EMU, **the debate quickly moved towards the fragmentation and potential distortions in the newly formed euro area public debt market.** The Giovannini Group Report (2000) presented four options for an increased coordination in this domain, reaching from more technical coordination for debt issuance to supranational debt, lent on to EU member states[4]. On a different note, Boonstra (2005) proposed the creation of an EMU Fund to rectify the inability of financial markets to distinguish between 'virtuous' and 'profligate' member states, which had resulted in general yield convergence in the aftermath of the adoption of the euro. The EMU Fund would borrow money from capital markets, fully replacing national issuance, and lend at a differentiated rate calculated on each country's fiscal standing. In reflecting more genuine risk premia, the mechanism would raise borrowing costs for 'reckless' member states, incentivising budgetary discipline.

2. The European Investment Bank has been active in borrowing and lending since the 1960s, and so has the Commission (see, e.g. the 1978 New Community Instrument or Ortoli facility). However, the discussion of EU borrowing for the provision of loans to the private sector goes beyond the scope of this paper.
3. These bonds would have been backed by capital subscription according to Holland, while Delors' proposal (more modest in terms of financial volume) proposed a guarantee by the Community's budget.
4. First, integration could be enhanced through more technical coordination, by means of a common issuance calendar and bond design. Second, member states could issue an umbrella instrument composed of several country-specific tranches, each representing a separate but identical legal object. Third, an ad-hoc body could issue a bond backed by joint and several guarantees of the member states, which would contribute to reduced liquidity and derivatives premia. And fourth, a Community institution could issue supranational debt, on-lend funds to EMU countries to finance a considerable share of their debt (within the limits of the Stability and Growth Pact).

2.3. Debt mutualisation during the euro area sovereign debt crisis

Debt mutualisation rose once again to the top of the political debate when the burst of the financial and debt turmoil sparked doubts on the unity and viability of the single currency. In the early years of crisis, proposals mainly sought to address widening spreads and increasing borrowing costs. Accordingly, they suggested easing pressure on sovereigns through fresh supranational debt issuance (Gros & Micossi 2008, De Grauwe & Moesen 2009, Montaigne 2010, Suarez 2011). With the progression of the crisis, however, academics and policymakers alike increasingly sought to simultaneously address two key concerns: 1) skyrocketing borrowing costs threatening countries to lose access to capital, and 2) unsustainable public debt levels in the Eurozone. Accordingly, **the majority of the instruments proposed the creation of a treasury-like debt agency aimed both at pooling a share of existing national debt, and at issuing debt jointly guaranteed by the participating member states.**[5] A well-known proposal in this respect is that of 'Blue Bonds' (Delpla & von Weizsäcker 2010, 2011). Under the scheme, a share of national debt accounting for up to 60% of GDP would be transferred to a Stability Council. This stock would hence be transformed into extra-safe and liquid Blue Bonds, i.e. mutualised debt guaranteed joint and severally by the participating member states[6]. For needs surpassing the 60% cap, countries would instead issue their own Red Bonds, i.e. purely national obligations, whose juniority and higher risk were to increase borrowing costs, thereby enhancing fiscal discipline. Several proposals shared the underlying premises of Blue Bonds, while differing in technical features like the institutional solutions, bond design, scope of participation, and share of mutualised debt (Leterme 2010, Juncker & Tremonti 2010, Münchau 2011, Amato & Verhofstadt 2011, Philippon & Hellwig 2011, Varoufakis & Holland 2011, European Commission 2011, EESC 2012, Vox 2012, Tommaso Padoa-Schioppa Group Report 2012).

In spite of many similar proposals towards some form of Eurobonds, the actual European response to the crisis fell short of establishing any treasury-like permanent institution for the euro. First, in May 2010 the Commission created the European Financial Stability Mechanism (EFSM). In the context of its supranational debt issuance program guaranteed by the Union's budget with a maximum capacity of EUR 60 bn. Second, ECOFIN established the European Financial Stability Facility (EFSF), a temporary limited liability company under Luxembourg law, raising funds up to EUR 440 bn thanks to the guarantees of its stakeholders, i.e. Eurozone governments. Third, the European Stability Mechanism (ESM) was established as an intergovernmental financial institution outside the treaty framework, with a maximum lending capacity of EUR 500 bn and replacing the EFSF as a permanent institution. **Rather than pooling any past or future debt, all these mechanisms were built on the tried-and-trusted logic of mutualisation of borrowing costs,** providing emergency credit access to struggling economies. With the exception of the ESM, the facilities were of temporary nature, and none of them provided a permanent stabilisation mechanism, opting instead for a recourse of last resort in times of economic and financial hardship.

5. While most proposals envisioned joint and several guarantees to minimize perceived credit risks, some authors suggested a several guarantee (De Grauwe & Moesen 2009, Option 3 European Commission 2011, Delors et al. 2011), while proposals on the creation of a euro-area safe asset backed by sovereign bonds (Synthetic Eurobonds: Beck et al. 2011, ESBies: Brunnermeier et al. 2012) did not require explicit public guarantees.
6. Under a joint and several guarantee/liability, each party is responsible for the totality of the outstanding debt, hence offering the highest level of security to investors thanks to the credibility of the strongest participants. Under a several (not joint) structure, parties are only responsible for their own share of the common obligations (for a more detailed discussion, see Waibel 2016).

2.4. Proposals for debt mutualisation in post-crisis EMU reform debates

During the sluggish recovery from the Great Recession, debate on debt mutualisation abated but did not completely vanish. On the one hand, different contributions refined and adapted the main proposals that had emerged in the previous years[7]. In particular, there was **a renewed interest for approaches that limited the degree of mutualisation and joint liability as much as possible,** perhaps due to how politically toxic these issues had proven to be during the euro area sovereign debt crisis. Drawing from Beck et al. (2011) and Brunnermeyer et al. (2012), the potential of creating securities backed by tranches of national sovereign bonds was revisited (Brunnermeyer et al. 2016, Bénassy-Quéré et al. 2018, European Systemic Risk Board 2018, Leandro & Zettelmeyer 2018a, 2018b). This safe and liquid asset would ensure financial stability and reduce bank exposure, performing in many respects as a de-facto Eurobond[8]. On the other hand, the crisis prompted reflections by EU institutions and governments on how to strengthen the EMU architecture, whose fragility was underscored by the crisis. Discussions concentrated on the creation of a macroeconomic stabilisation function at the European level[9]. More generally, however, the debate on Eurozone reform paid little attention to joint borrowing and debt mutualisation, with the 2015 Five Presidents Report, the 2017 Commission Reflection Paper on the Future of EU Financing, as well as the final proposal for the Budgetary Instrument for Convergence and Competitiveness (BICC) remaining silent on these matters.

2.5. Covid-19 and renewed calls for European debt mutualisation

The outbreak of the Covid-19 pandemic reignited calls for debt mutualisation and joint issuance in the EU. The dominating concern were and are the high costs that some member states will have to incur to support the economy and stimulate recovery. The initial European response resorted to existing or familiar mechanisms. Following the April Eurogroup meeting, ministers endorsed the activation of an ad-hoc Pandemic Crisis Support ESM facility, based on the existing Enhanced Conditions Credit Line, as well as the Commission's SURE, an EFSM-like temporary mechanism to support national short-time work compensation schemes. Critics, nevertheless, pointed to the inadequacy of these instruments alone in face of the magnitude of the economic shock and the risks for long-term divergence across member states. Therefore, **discussions shifted towards the need to introduce a temporary mechanism to mutualise the costs of the crisis through a one-off joint or supranational bond issuance**. In contrast with the Great Recession, proposals did not suggest the pooling of pre-existing national debt, nor the creation of permanent treasury-like bodies (with the exception of Claeys & Wolff 2020; Codogno & van den Noord 2020). Rather, the solutions

7. See, for example, Cioffi et al. 2019; Corsetti et al. 2015 and Bini Smaghi & Marcussen, 2018 for varieties of the Redemption Fund and Blue Bond proposals.

8. The attractiveness and relatively easy deployment of this instrument led the Commission to present in May 2018 a proposal for its creation, that has nevertheless been stalling in the Council ever since.

9. Macron & Gabriel (2015), Monti et al. (2016), and Arnold et al. (2018), among others, suggested institutions of euro-area budget/centralised fiscal capacity that can borrow from capital markets. In 2018, the Commission proposed a EUR 30 bn European Investment Stabilisation Function (EISF), on the model of the EFSM, that would increase its budget-backed issuance for back-to-back loans to member states in times of economic downturn.

presented were all crisis-contingent, and pointed to the existing issuance capacity of the Commission (French non-paper 2020, Garicano & Verhofstadt 2020, EP resolution 2020, Franco-German proposal 2020, Frugal Four non-paper 2020) or the ESM (Claeys & Wolff 2020; Hüter et al. 2020; Bénassy-Quéré et al. 2020).[10] The sense of urgency also prompted the choice for integrating the response to the crisis into the ongoing negotiations for the Union's 2021-2027 MFF. Commission President von der Leyen, an early supporter of this approach, pointed to the need for "quick answers" and that the EU could not "take two or three years to invent new tools" (Rios 2020). Accordingly, while early proposals (Giavazzi & Tabellini, 2020; Claeys & Wolff 2020; Hüter et al. 2020; French non-paper 2020, Grund et al. 2020) called for Member States' guarantees (either joint and several or several[11]), the idea to utilise the EU budget both as a guarantee and the vehicle for disbursement progressively consolidated as the dominant approach (French non-paper 2020, Garicano & Verhofstadt 2020, Spanish non-paper 2020, EP resolution 2020, Franco-German proposal 2020).

Moreover, **most proposals increasingly rejected the logic of cheap loans that had been dominant during the euro area sovereign debt crisis**[12], pointing to the symmetric nature of the crisis, the absence of moral hazard, and the burden it would represent on the already-bleak fiscal position of some countries. They recommended a grant-based approach instead, where the repayment of principal and interest would be spread over a long period of time and based on a reimbursement key considering parameters like population or GDP (Nine country proposal 2020, French non-paper 2020, Claeys & Wolff 2020; Grund et al. 2020). As it will be explored in the following section, an additional point of contention was whether assistance should be subject to policy conditionality (Frugal Four non-paper 2020), conditionality of purpose (French non-paper 2020, Grund et al. 2020, Gentiloni & Breton 2020), or no conditionality at all.

In this context, on 27 May 2020 the Commission proposed the creation of a EUR 750 bn instrument called Next Generation EU, to support recovery efforts from January 2021 to December 2024 (European Commission 2020). According to the plan, the Commission would raise funds on behalf of the EU, backing the unprecedented volume borrowed with a temporary increase of the EU budget´s own resources ceiling, thereby avoiding the need for direct member state guarantees. To do so without weighing on national contributions to the upcoming MFF, the Commission suggested introducing new own resources, including taxes on carbon emissions, digital transactions, and large corporations. **Besides its financial magnitude, the key innovation of the recovery instrument lies in its disbursement logic.** In fact, while a third of the funds available could finance loans to Member States, the bulk of the proceeds (EUR 500 bn) would be allocated in the form of grants channelled through the EU budget. Repayment would hence take place in the context of the next MFF negotiations, and in any case after 2027 and before 2058.

10. A notable exception being the EFSF-like special purpose vehicle advanced in the French non paper (2020).
11. See footnote 6 for the distinction between joint and several, and several guarantees.
12. A prominent early proposal calling for an ESM-based solution is Bénassy-Quéré et al. (2020).

3 ▪ SOLIDARITY AND RESPONSIBILITY MECHANISMS FOR EUROPEAN DEBT MUTUALISATION

The plethora of proposals and instruments described above shows how varied the debt mutualisation debate has been throughout the past decades, but also which commonalities can be found across time. **What all these arrangements have in common is the effort to provide mechanisms for solidarity and responsibility, addressing identified problems in Europe jointly through debt mutualisation.** Particularly since the euro area sovereign debt crisis, proposals and initiatives detailing specific solidarity-responsibility arrangements have become increasingly prominent. The following subsections discuss the constituting elements of such arrangements. They consider different features of solidarity (foundations, function, form, nature, and scope), as well as the way in which responsibility mechanism are supposed to ensure that solidarity is not abused.

3.1. Foundations of solidarity

As Fernandes & Rubio (2012) have shown, **inter-state solidarity in the EU can be understood in terms of two rationales: direct reciprocity and enlightened self-interest**. Direct reciprocity is based on an insurance-like approach spreading risks among Member States against unpredictable events. Enlightened self-interest, on the contrary, is driven by the awareness that helping a Member State benefits the community as a whole and, ultimately, the 'benefactor' itself. **In the Union, ambitious insurance-like mechanisms have generally lacked, and solidarity has mainly been exerted through instruments based on enlightened safe-interest.**[13] However, this has mainly been the case for inter-state transfers related to EU budget expenditures – with cohesion funds being the most prominent example – which can somehow ease the potential concerns from 'creditor' countries thanks to their pre-determined, predictable and relatively transparent allocation. The same could be hard to ensure in the context of a permanent tool for joint debt financing to counter asymmetrical shocks and support counter-cyclical fiscal policy in the Eurozone. To some extent, this can explain why governments have been reluctant to introduce solidarity mechanisms in this respect, in spite of the suggestions of most academic contributions. Instead, as outlined above, solidarity in the EMU based on debt mutualisation has by and large taken the form of temporary, emergency-relief mechanisms aimed at avoiding scenarios that would have otherwise threatened the survival of the Eurozone as a whole. Despite its permanent character, the ESM follows this same logic. It remains a last-resort institution for exceptional economic distress, coming with punitive conditionality for countries requiring support.

In principle, the symmetric and unpredictable character of the Covid-19 crisis pleads in favour of insurance-like approaches. As noted by Claeys and Wolff (2020), the "veil of ignorance" should incentivise a relatively rapid deployment of a mechanism based on direct reciprocity. This, however, became less palatable as it became clear that some Member States would be affected more than others (at least in the short run), making the division between potential beneficiaries and remitters increasingly evident. **Hence, the debate has moved towards a logic of enlightened self-interest, with advocates of solidarity stressing the economic rationale of a joint response, due to the interconnectedness of the Single Market.** This approach is also the one adopted by the Commission's Next Generation EU, that highlights how "[it] is in our common interest to support the hardest hit, strengthen our Single Market and invest in our shared European priorities" and that "a euro invested in one country is a euro invested for all."

13. Insurance-like mechanisms do exist (e.g. EU Solidarity Funds) but are minor.

3.2. Functions and forms of solidarity mechanisms

The different proposals put forward in the past decades demonstrate that solidarity through debt mutualisation can have different functions. We identify four main types: **(1) provide macro-economic assistance to Member States in times of economic turmoil, (2) restore public finances and improve fiscal discipline, (3) enhance convergence and integration in the EMU, and 4) support national expenditure or investment to prevent procyclicality** (e.g. proposals centred on project financing). The first and third functions have been the most examined. During the financial crisis, calls for solidarity foresaw a deep institutional and governance reform of the EMU, deepening integration and cooperation among Member States by increasing their liability for one-another and vis-à-vis the markets. The central function of solidarity was to overcome the pitfalls of a monetary union without a fiscal union. Conversely, mechanisms like the Community Loan, the EFSM, and the EFSF/ESM employ a conception of solidarity that is functional to the provision of ad-hoc macroeconomic support, thereby countering liquidity and solvency concerns. This cleavage has not prominently emerged in the present debate, with most proposals concurring with the case of providing crisis-specific assistance, without an upheaval of the system.

The functions of solidarity can potentially be achieved through different forms of solidarity. **For long, the dominance of "cheap loans" signified that solidarity took the form of a mutualisation of borrowing costs**. The main merit of this approach during the Great Recession was that supranational or joint issuance reduced the high borrowing costs due to the explosion of sovereign bond spreads. In 2020, however, this approach has lost much of its relevance. The early involvement of the European Central Bank (ECB) with its Pandemic Emergency Purchase Programme (PEPP) had succeeded in maintaining spreads in a narrow band and keeping yields at low levels, a policy option that did not seem available before 2012. **Proposals have progressively stressed the need for solidarity to take the form of a mutualisation of debt repayment**. This way, the costs of the crisis would genuinely be shared among Member States, underpinned by the acknowledgement that no country could be blamed for the viral outbreak and its effects. A first of this kind, the Commission's Recovery Instrument goes precisely in this direction, with the principal repayment being based on a pre-established contribution key.

3.3. Nature and scope of solidarity mechanisms

The nature and scope of solidarity mechanisms can vary considerably. It has already been explored that while during the financial crisis most commentators proposed permanent mechanisms comprising ad-hoc institutional solutions, the circumstances of the Covid-19 crisis urged a temporary solution without new structures. Instruments vary also in terms of financial volume. Although early proposals were relatively modest, ambition increased with time (going as far as to fully replace national debt issuance, see the 2011 Green Paper of the European Commission), often contingent to the specific needs of each period. Indeed, **the unprecedented EUR 750 bn firepower proposed by the Commission goes well beyond any instrument adopted during the euro area sovereign debt crisis** (including the ESM, whose lending capacity is by treaty capped at EUR 500 bn). Liability and guarantees also affect the degree of solidarity granted by an instrument, with the two main debated options being several (the current design of EIB and ESM bonds) and joint and several guarantees (still lacking in the EU so far). As described above, repayment conditions also play an important role, including the maturities of joint debt. While concerns over member states' liquidity during the euro area sovereign debt crisis led to some proposals focusing on very short-term maturity instruments (Philippon & Hellwig 2011), **during the Covid-19, the option of issuing perpetual bonds (i.e. bonds with no maturity) gained significant traction for the first time** (Giavazzi & Tabellini 2020; Soros 2020; Spanish non-paper 2020; Garicano & Verhofstadt 2020).

This heterogeneity in the nature and scope of solidarity mechanisms can indeed be used to the benefit of solidarity. The 2011 Commission's Green Paper and the 2012 European Parliament report by Sylvie Goulard proposed, for example, a phased roadmap implementing mutualisation in several stages with different degrees of ambition. In other respects, this also allowed policymakers to experiment alternatives and mix-and-match different solidarity mechanisms grouping them under an overall response. This was the case for rescue packages including bilateral loans, EFSM, EFSF and ESM support, as well as for the four-pronged Covid-19 crisis response endorsed in April 2020 and built around the diverse tools of the EIB, ESM, SURE and a Recovery Fund.

3.4. Responsibility mechanisms

As noted by Vignon (2011), **solidarity among countries can only be created and sustained if it is matched by an equal degree of responsibility.** Responsibility, in this context, has several meanings, such as using the funds provided through solidarity mechanisms in an appropriate manner and to be accountable towards those providing support. A prominent example for a solidarity-responsibility arrangement is the euro, which provided solidarity by eliminating exchange rate risks for participating countries in exchange for responsibility in the form of fiscal discipline, as required by the Stability and Growth Pact (SGP). The underlying logic for this arrangement is to counteract moral hazard, seeking to prevent the implementation of mechanisms that would incentivise abuse of solidarity, such as reckless spending of particular member states in the framework of the euro area. Different proposals and actual implementations of solidarity-responsibility arrangements have included four main types of responsibility mechanism to deal with moral hazard: **(1) market discipline, (2) fiscal rules compliance, (3) policy conditionality, and (4) soft policy control/budgetary governance.**

Market discipline should occur naturally when a sovereign exceeds sustainable borrowing levels and creditors request higher risk premia. Joint or supranational issuance, however, may "jam" this mechanism as free rider and moral hazard issues emerge. As a consequence, **most authors have proposed that joint borrowing be complementary to national borrowing, capping the share of the former and making additional national issuance more expensive by 'juniorising' it and increasing its risk profile** (Delpla & von Weizsäcker 2010, 2011). Other contributions have proposed 'artificial' market discipline mechanisms to enhance responsibility by applying a differentiated – but generally still favourable – lending rate that would reflect a member state's fiscal standing[14].

As highlighted above, the respect of fiscal rules has also been topical since the introduction of the euro, with several reforms since the 1990s to ensure at least a minimal degree of fiscal policy coordination across the EU. Several proposals on debt mutualisation stated that any joint borrowing had to come with more stringent fiscal rules as a responsibility mechanism,

14. The most notable example in this regard is Boonstra (2005), although higher-than normal rates were also applied with this goal in early rescue packages to Greece.

as existing mechanisms were insufficient to ensure rule compliance. In practice, this meant that preconditions were to be established prior to the participation in any common debt scheme, including closer application of existing constraints (Delpla & von Weizsäcker 2010, 2011; European Commission 2011; Philippon & Hellwig 2011), adherence to long-term debt reduction plans (Varoufakis 2011), as well as the introduction of constitutional guarantees (Bofinger et al. 2011). **Discussions on fiscal rules compliance have, however, at least temporarily lost their relevance during the Covid-19 crisis, as EU institutions and national governments decided to suspend the existing fiscal rules to allow countries to adequately respond to the challenges at hand.**

With the exception of instruments based on project financing, policy conditionality has been a well-known constant in proposals and actual implementations of debt mutualisation in Europe. The MacDougall Report (1977) made reference to "performance conditionality," and countries turning to the Community Loan were required to first agree with the Council on a set of policies to address the balance-of-payments issues they faced. Conditionality became particularly important during the euro area sovereign debt crisis, where moral hazard was perceived as a preeminent risk of joint action. This resulted in strict Memoranda of Understanding between the national governments of crisis countries and EU institutions, imposing the implementation of tough and unpopular austerity measures in exchange for manageable borrowing costs. Structural reforms were also recognised as essential in the wider policy and academic debate. This general ethos can be ascribed to the nearly unanimous interpretation of the crisis as a result of reckless government behaviour among key policymakers (Fernandes & Rubio 2012). The need to 'right' this 'wrong' and reprimand it with broad reforms has been mostly absent in the Covid-19 crisis so far, not considering any country to be particularly at fault themselves. While the rejection of any stringent policy conditionality has been predominant, the 'Frugal Four' and some other commentators have contested this thinking, insisting that the "strong commitment to reforms and the fiscal framework is essential to promote growth" (Frugal Four non-paper 2020). But even the ad-hoc ESM credit line did eventually not hold any policy strings but introduced a soft 'conditionality of purpose' committing countries to utilise resources exclusively for direct and indirect health-related expenditures.

A final responsibility mechanism we identify is based on budgetary governance and soft policy control. The most relevant example in this regard is the European Semester, the governance method through which Member States coordinate their economic and fiscal policy since 2010. This process is based on budgetary and macroeconomic surveillance in the wider context of the SGP, as well as on detailed multi-domain policy guidance through country-specific recommendations (CSRs)[15]. To stimulate compliance, since 2014 the disbursement of European Structural and Investment Funds (ESIF) has been linked, to a limited extent, to the financing of investment and reform proposed in the context of the Semester (European Commission 2017). **Soft policy control mixes classic policy conditionality and fiscal compliance, while at the same time going beyond them due to a more participative and less stigmatising working method and an incentive-based approach.** Nevertheless, due to its recent introduction **it has largely been ignored in the debate of debt mutualisation**, which has focused instead on stricter and more intrusive conditionality.

The responsibility mechanism advanced in the Commission's Next Generation EU goes in the direction of soft policy control. In the proposed regulation, prior to receiving assistance,

15. These CSRs are the result of consultations between the Commission and each Member State, and are formally adopted by ECOFIN with a qualified majority.

member states would have to present a "recovery and resilience plan" to the Commission, detailing investment and reform policies to be financed by the Recovery and Resilience Facility (RRF)[16]. These policies would need to be in line with the priorities identified inside the European Semester and its CSRs, as well as an additional set of criteria. The Commission would finally approve the plan (subject to a veto from the Council) and grant assistance following the achievement of predetermined milestones and measurable targets. **In the run up to the European Council of July 17 and 18, however, member states have expressed diverging stances regarding the method and the stringency according to which policy control should be implemented**. While some countries (notably Italy) remain opposed to any type of conditionality, others (including the Netherlands and the German Council Presidency) advocate for a stronger accountability system, which includes moving the final disbursement decision from the Commission to the Council, acting by unanimity. **The final design of the RRF responsibility mechanism remains therefore highly uncertain, with decisive discussions among national leaders to come.**

4 ▪ THE LEGITIMACY OF EUROPEAN SOLIDARITY-RESPONSIBILITY ARRANGEMENTS

As the previous sections have shown, any project of European debt mutualisation comes with particular arrangements of solidarity and responsibility mechanisms. But for any such arrangement to be economically and politically viable, it needs to be legitimate for political decision-makers and citizens across EU member states (see Schmidt 2015). This includes all of its three dimensions: output, input, and throughput legitimacy. In practice this means the following: To achieve output legitimacy, solidarity-responsibility arrangements need to be economically effective. Joint borrowing and the criteria attached to it should thus provide for European-wide macroeconomic stabilisation, foster economic growth across member states, support economic convergence, and help to achieve broader supranational and national economic policy objectives. To ensure input legitimacy, solidarity and responsibility mechanisms have to respect fundamental requirements of national sovereignty, such as sufficient national democratic control over revenue and spending priorities.[17] In terms of throughput legitimacy, procedures and criteria for European debt mutualisation, the spending of raised funds, and their repayment, need to be transparent and allow for accountability across different levels of government. Critically, however, **many past proposals but also implementations of European debt mutualisation have suffered from a lack of input legitimacy across participating countries, stemming from unequal negotiation positions and unbalanced solidarity-responsibility mechanisms.** Arrangements which are negotiated under the influence of external economic and political pressure and that imply an uneven distribution of benefits and obligations tend to lack domestic legitimacy at least among certain member states. This can subsequently lead to backlashes against certain solidarity-responsibility mechanisms, other member states or the EU more broadly.

16. The RRF is the tool through which three quarters of the funds raised by the Recovery Instrument (EUR 560 bn, of which EUR 310 bn in the form of grants and up to EUR 250 bn in the form of loans) would be channelled.
17. This does not imply that there should not be any common rules or guidelines across EU member states. Rather it means that - inside common economic and political frameworks - democratic decision-making and priority-setting needs to be protected.

4.1. The legitimacy of solidarity-responsibility arrangements during the euro area sovereign debt crisis

A case in point of unbalanced solidarity-responsibility mechanisms are the different ad hoc arrangements made during the euro area sovereign debt crisis, finally formalised with the ESM. Crisis-specific solidarity mechanisms to mutualise borrowing costs were linked with very strict and intrusive policy conditionality imposed by the so-called Troika (consisting of the European Commission, the ECB and the International Monetary Fund). As Schmidt (2015) has highlighted, this arrangement had negative effects on all three dimensions of democratic legitimacy[18]. From the viewpoint of 'debtor' countries, limited solidarity mechanisms did not go far enough to justify the highly intrusive actions of creditors in their country, basically suspending national democracy on a temporary basis. Only considerably more 'generous' forms of solidarity (such as a mutualisation of debt repayment) or stronger limits to conditionality could have made the solidarity-responsibility arrangement more legitimate in their view. From the perspective of the 'creditor' countries, providing solidarity (through the mutualisation of borrowing costs) without strong responsibility mechanisms (including strict fiscal rules and conditionality) was considered an unfair burden on their citizens for bailing out other countries that got into trouble due to what they considered 'bad' national policy choices. Beyond these problems for input legitimacy, the externally imposed reform measures against financial support during the euro area sovereign debt crisis also tended to suffer from shortcomings in output legitimacy, as their design was often inadequate and implementation was constantly contested from domestic actors in crisis countries, partially undermining certain reform measures.

During the euro area sovereign debt crisis, many proposals were also made for a more permanent form of solidarity, mutualising a significant share of existing national public debt at the European level. For the 'debtor' countries, such a less limited solidarity mechanism (in terms of both scope and time), often coupled with responsibility mechanisms based on reinforced fiscal rules or strengthened market discipline for the remaining parts of national public debt, would have been considerably more legitimate. While imposing strong limits on further public deficits, the more indirect fashion of responsibility mechanisms would have still allowed for more domestic flexibility to set revenue and spending priorities. This is something which was often absent due to the intrusive conditionality requirements of the solidarity-responsibility arrangements that were actually implemented during the euro area sovereign debt crisis. Among the 'creditor' countries there were major concerns about the domestic legitimacy of European-wide solidarity-responsibility mechanisms based on such a form of 'unlimited' solidarity. Proposals grounded in comprehensive and permanent debt mutualisation were not seen as legitimate enough on the input dimension, even if such an approach might have been economically sensible across the EU (in terms of output legitimacy). The 'moral hazard' argument was very present in these considerations.

18. In terms of effectiveness, EU-imposed austerity and structural reform policies largely participated in exacerbating the economic recession rather than dampening their effects (lack of output legitimacy). At the same time, the externally imposed measures by the Troika in crisis countries led to the sentiment among these member states' citizens that their domestic governments were not responsive to their preferences (lack of input legitimacy). Furthermore, throughput legitimacy was "compromised by rescue plans lacking in efficacy as well as by governance processes focused on restrictive rules and numerical targets lacking sufficient accountability, transparency, and inclusiveness" (Schmidt 2015:11).

4.2. The legitimacy of solidarity-responsibility arrangements during the Covid-19 crisis

Early in the Covid-19 crisis, European leaders saw the necessity to rethink the strict responsibility mechanisms attached to the ESM. Deeming the coronavirus crisis not a source of moral hazard, member states agreed on lifting the generally intrusive conditionality requirements of the ESM and additionally introduced the SURE mechanism. As the type and depth of crisis lifted input legitimacy concerns among the 'creditor' countries, the new solidarity-responsability arrangements became also considerably more legitimate for 'debtor' countries. The absence of intrusive conditionality mechanisms, interfering with national democratic decision-making, significantly improved the input legitimacy of crisis-specific support through the mutualisation of borrowing costs. This outcome was also due to the above-mentioned early involvement of the ECB, which ensured from the onset of the coronavirus crisis through its bond purchasing programmes that member states were not coming under overly strong economic pressures, which would have made negotiations more lopsided.

As the Covid-19 crisis has had an increasingly asymmetric impact on EU member states, hitting hard particularly those countries that were already the most affected during the euro area sovereign debt crisis, many proposals for a more powerful temporary solidarity mechanism were made, circling around different options for the mutualisation of debt repayment. Common to most of these proposals, and exemplified in the Commission's Next Generation EU plan, is a grant-based solidarity mechanism, which is limited both in terms of size (even if generous) and duration, while spreading debt repayment far into the future.

For 'debtor' countries this largely grant-based approach would constitute a game changer in European solidarity, as some countries hit particularly hard by the crisis will most likely receive considerably more money than they will ever have to pay back, creating an – at least temporary – macroeconomic stabilisation function in the EU. This would help to reduce the expected increase in economic divergences across member states and provide urgently needed funds to improve long-term productivity growth. As grants handed out by the EU are not money raised through domestic tax revenues and do not have to be paid back (beyond a predetermined share of EU GNI), it also makes the attachment of criteria linked to these funds considerably less problematic in terms of input legitimacy for 'debtor' countries. A constant problem with previous proposals and the conditionality attached to loans during the euro area sovereign debt crisis was that it seriously interfered with the capacity of national parliaments to decide over the size and mix of taxation and expenditures. As money raised via the Commission proposal's approach to debt mutualisation is additional (and any debt repayment following a quite indirect logic), it should be more acceptable to countries benefitting especially from disbursed funds to follow strict criteria on their exact spending. In addition, it is the member states that are supposed to propose the set of domestic investment priorities, giving some more room for input legitimacy.

From the side of the 'creditor' countries, agreeing on a solidarity mechanism based on a mutualisation of debt repayment is a huge step and potentially a challenge for domestic input legitimacy. The main issue in this regard is that while limited in overall term, national debt repayment quotas are not capped at a pre-defined budget figure, but rather depend on the development of national economies in the future. This creates uncertainty for domestic policymakers and citizens even if this logic constitutes a sort of insurance mechanism against unfair burden-sharing in the decades to come. There are, however, also a number of features of the currently prominent proposals that counteract broader problems with input legitimacy among 'creditor' countries. First, as basically all currently discussed proposals for a joint debt issuance are based on a temporary and capped solution, input legitimacy is not challenged permanently, something which has been an issue for input legitimacy with Eurobonds proposals. Such a solidarity mechanism does not equate to a 'transfer union' as feared by certain political parties among 'creditor' countries. Second, attaching concrete criteria to the disbursement of funds from jointly raised debt that is in line with the domestic policy priorities of 'creditor' countries and broader European priorities adds an element of input legitimacy for this country group. And third, as several new European taxes are discussed – and their adoption seems increasingly likely as also some of the 'Frugal Four' push for such taxes (e.g. Austria) – citizens in 'creditor' countries might not lose any significant capacity to decide over national revenue and expenditure priorities in the future.

As the discussions on the Commission proposal for a Recovery Instrument have increasingly turned towards the type and extent of conditionality, and the policy control procedures for granting and disbursing grants and loans, concerns about throughput legitimacy have come to the fore that are less present in other solidarity-responsibility arrangements. While, as discussed above, the attachment of some concrete conditionalities to grants seems justifiable in terms of input legitimacy across EU country groups, it is important that national recovery and resilience plans and their approval at the European level are not becoming a pawn in political games between different member states. Key attention will have to be paid to transparent and accountable procedures that, on the one hand, ensure that disbursed funds are used accordingly to the criteria set out jointly, and, on the other hand, prevent that individual member states can hold other ones hostage, withholding funds if the latter do not heed to broader policy preferences of the former. Only with clear criteria and unpoliticised procedures throughput legitimacy can be established.

5 ▪ CONCLUSION - A SOLIDARITY-RESPONSIBILITY MECHANISM FIT FOR EUROPE'S FUTURE

This paper has shown that mutualising debt at the European level is nothing new but has repeatedly been a tool to address common crises. Joint borrowing has always been linked with specific arrangements of solidarity and responsibility mechanisms that set out the conditions for its distribution, disbursement and repayment. Importantly, we have highlighted that for such solidarity-responsibility arrangements to properly work, they need to have sufficient input, output and throughput legitimacy across EU member states. Previous instances of European debt mutualisation, such as the ad hoc arrangements and the ESM of the euro area sovereign debt crisis, have not passed this test especially among the 'debtor' countries, as intrusive conditionality negatively affected domestic input legitimacy. In contrast, proposals for comprehensive and permanent debt mutualisation were not deemed legitimate by 'creditor' countries during the last crisis. With the Covid-19 crisis several contextual elements have changed, and open the room for more legitimate solidarity-responsibility arrangements of joint borrowing: The early decisive actions of the ECB have helped to safeguard previous crisis countries from immediate economic pressures, allowing for a more equal starting point for negotiations. The type of crisis induced by the coronavirus is also less damaging to trust between EU member states than the euro area sovereign debt crisis, with its ubiquitous concerns about moral hazard.

As our analysis suggests, **the solidarity-responsibility arrangements contained in most of the recent proposals for European debt mutualisation** (including the current Commission proposal) **have the potential to overcome some of the legitimacy problems of previous solidarity-responsibility arrangements, both for 'debtor' and 'creditor' countries.** Especially regarding input legitimacy across country groups, a crisis-specific solidarity mechanism of defined size but based largely on grants linked with concrete conditionality for their disbursement seems promising. In the upcoming discussions in the European Council, negotiators should not deviate from these principles. Facing the biggest economic challenge to the Union so far, **'creditor' countries have to realise that providing substantial solidarity with countries hit hard by the coronavirus through grants is in their own 'enlightened self-interest' of a prosperous Europe.** An exclusive focus on loans or an insufficient amount of grants will fall short of a much-needed macroeconomic stabilization function to weather the Covid-19 crisis, a message that the 'Frugal Four' should take at heart[19]. **Solidarity based on grants, however, should also considerably reduce input legitimacy concerns about concrete criteria for grant disbursement among 'debtor' countries.** While the intrusive and punitive policy conditionality and their scaring effect for crisis countries during the euro area sovereign debt crisis should never return in Europe, some conditions for the spending of grants financed through European debt should be legitimate for 'debtor countries'. We deem conditions attached to grants (and loans) as legitimate, when they are targeted towards appropriate spending, following common and urgent policy priorities set out together at the European level, especially regarding crucial issues such as climate change. **The criteria attached to grant disbursement should be concrete, but they should also not unduly interfere with national sovereignty to avoid repeating the mistakes made during the last crisis, where solidarity-responsibility arrangements were unbalanced and thus largely illegitimate for hard-hit countries.** Member states should be allowed to set their policy priorities – beyond the criteria attached to the money raised at the supranational level and the common priorities set out at the European level – largely by themselves. Imposed structural reforms would only lead to a further backlash against the EU, carried by populist anti-European parties. By finding the right balance of input legitimacy among 'debtor' and 'creditor' countries, solidarity-responsibility arrangements will be perceived as a success on both sides of the discussion.

In order to guarantee throughput legitimacy, moreover, we argue that a participative, accountable and incentive-based method to grant and disburse the funds from joint borrowing must be adopted. Granting the Council unanimous decision-making prerogatives for fund disbursement, as some have recently suggested, can be harmful and counterproductive. This could lead to a process that at best is reminiscent of bail-out package negotiations during the debt crisis, and that at worst incentives backdoor deals whereby governments withhold or grant aid based on political favours or vendettas rather than objective criteria. Accordingly, **the Commission's role in assessing national recovery and resilience plans (similar to CSRs) should be maintained, with democratic control being ensured via the Council (acting by qualified majority) and the European Parliament (which is currently absent in the Commission's proposal).**

In order to respond to the greatest challenge in its history, the EU member states should make a bold step towards European debt mutualisation. For such a step to be successful, however, European leaders need to agree on a solidarity-responsibility arrangement which can balance output, input and throughput legitimacy across the EU.

19. The joint negotiations on the next MFF and a European Recovery Instrument should not serve as a temptation - especially for 'creditor' countries - to (mis)use funds from joint borrowing to finance core parts of the EU budget to lower their contributions for the period from 2021 to 2027.

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